News from CFALA

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Government Caused, Prolonged and Worsened Financial Crisis, Respected Stanford Professor John Taylor Tells CFALA Members

LOS ANGELES – The primary causes of the current financial crisis were government actions and interventions, not sub-prime mortgages, misbehavior on Wall Street or any inherent flaw in the U.S. economy, Stanford University Professor John B. Taylor told attendees at the annual meeting of the CFA Society of Los Angeles (CFALA) Wednesday night.

The crisis developed following predictable – and avoidable – patterns, Taylor said, with monetary excesses leading to a housing boom and subsequent bust. He cited the Federal Reserve Board's policy of keeping interest rates artificially low between 2003 and 2005 as the primary culprit, abetted by risky mortgages, mortgage securitization, poor performance by rating agencies, and government policies that greatly expanded the mortgage portfolios of Fannie Mae and Freddie Mac. Once the crisis hit in the summer of 2007, government proceeded to make it worse, Taylor said.

"Government actions helped prolong the crisis," Taylor told about 200 members of CFALA, a 78-year-old network of Southern California investment professionals that promotes economic and financial education and high ethical standards.

"Early on, policy makers misdiagnosed the crisis as one of liquidity and prescribed the wrong treatment," he said.

Rather than addressing the foundational issue of counterparty risk and focusing quickly on the quality and transparency of bank balance sheets, the government's response was a year's worth of ineffectual measures, Taylor said. These included the 2007 Term Auction Facility (TAF), the initial consumer stimulus package, extreme reductions in the Fed Funds rate, and a short-on-specifics but long-on-spending $700 billion Troubled Asset Relief Plan (TARP) that spooked the public and the markets. Ad hoc decisions to save one financial institution but not another added to the perception that the government did not have a coherent plan of response, Taylor said.

"It did not have to be this way," he said. "To prevent misguided actions in the future, it is urgent that we return to sound principles of monetary policy, basing government interventions on clearly stated diagnoses and predictable frameworks for government actions. Massive responses with little explanation will probably make things worse. That is the lesson from this crisis so far."

Taylor is a professor of economics at Stanford University and a senior fellow at the Hoover Institution. He is widely known for his research on the foundations of modern monetary theory and policy, and his “Taylor Rule” on how central banks should develop monetary policies has been followed by governments around the world. In essence, the Taylor Rule presents a formula for central banks to set short-term interest rates that is based on inflation rates and the gap between actual and trend Gross Domestic Product and is therefore consistent and predictable by financial markets.

Taylor’s latest book is “Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis,” which offers empirical research on the current financial crisis.

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